Principles for Responsible Investment

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

SHIFTING PERCEPTIONS:

ESG, CREDIT RISK AND RATINGS

APRIL 2023

PART 4:

DEEPENING THE DIALOGUE BETWEEN INVESTORS, ISSUERS AND CRAs

The ESG in Credit Risk and Ratings Initiative is funded by the Gordon and Betty Moore Foundation through the Finance Hub, which was created to advance sustainable finance.

THE SIX PRINCIPLES

PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1 **We will incorporate ESG issues into investment analysis and decision-making processes.**

2 We will be active owners and incorporate ESG issues into our ownership policies and practices.

3 We will seek appropriate disclosure on ESG issues by the entities in which we invest.

4 We will promote acceptance and implementation of the Principles within the investment industry.

5 We will work together to enhance our effectiveness in implementing the Principles.

6 We will each report on our activities and progress towards implementing the Principles.

PRI's MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

CONTENTS

ABOUT THIS REPORT

This report summarises the work done, and progress made, during the second phase of the ESG in Credit Risk and Ratings Initiative, as well as highlighting industry challenges that still need to be addressed by fixed income investors, issuers and credit rating agencies.

The work has been informed by a series of surveys and workshops – participants to these can be found in Appendix 1, while an example of the discussion notes used to inform the sessions is provided in Appendix 2.

More information about the initiative.

FOREWORD

When the ESG in Credit Risk and Ratings Initiative was launched in 2016, few market participants anticipated how quickly environmental, social and governance (ESG) incorporation would pique the interest of fixed income investors in the ensuing years. At that time, many thought that ESG incorporation in fixed income meant only investing in green bonds. What's more, responsible investment practices were deemed to be primarily for equity investors, who, as shareholders, could more easily influence corporate practices.

Supporting PRI signatories that invest in fixed income assets to understand how ESG factors can alter credit risk seemed a natural starting point for our work, building the case for more formal ESG consideration. We also recognised that we needed to involve credit rating agencies (CRAs), whose rating opinions often limit the investment universe for investors constrained by specific levels of issuer credit quality.

Fast forward nearly seven years and it is clear that the initiative has been a true catalyst for several important changes that CRAs and investors have made. These range from improving analytics and increasing resources, to setting up frameworks that consider ESG factors more routinely in credit risk analysis, and not just when the occasional red flag is raised.

This would not have happened without the willingness of the initiative's supporters to engage, respond to our multiple speaking requests for events, shape talking points or participate in the many roundtables that we have organised. Putting competitive considerations aside, they have been open to frank exchanges, sharing practice, discussing challenges and, importantly, considering possible practical solutions to overcome the latter.

CRAs have responded in different ways. And while many investors maintain that credit ratings do not adequately reflect ESG risks or that they are not forward-looking enough, these investors also admit that they are having ESG conversations with CRAs that could not have happened a few years ago.

It has been my privilege to oversee this project from its inception and help it grow into one of the PRI's largest collaborative initiatives.

Carmen Nuzzo
Head of Fixed Income, PRI

I would like to thank members of the ESG in Credit Risk and Ratings Initiative committee – investors and CRA representatives alike – for their guidance, dedication and willingness to give up so much of their time to help this initiative progress and for ensuring that it responded to market participants' real needs.

Finally, thank you also to my colleague Sixtine Dubost, with whom I co-authored this report, for her tireless work and contribution to the second phase of the initiative. We look forward to continuing the dialogue and driving further progress among signatories.

EXECUTIVE SUMMARY

The second phase of the ESG in Credit Risk and Ratings Initiative, which this report summarises, has deepened the dialogue that the PRI started between investors and credit rating agencies (CRAs) in phase one. It has also broadened the outreach to other stakeholders – primarily borrowers, but also ESG information providers and investment consultants.

It has provided a unique forum for investors, CRAs and corporate issuers to engage, at scale, over a large breadth of sectors and in a way that rarely happens collaboratively, as most conversations tend to be bilateral (e.g., between investors and companies; CRAs and companies or investors and CRAs).[1]

KEY TAKEAWAYS

- **Appetite to continue dialogue:** Investors, CRAs and issuers want to continue these conversations jointly, because they assess the materiality of ESG factors differently, depending on their perspectives and objectives.
- **Creating a common understanding:** The dialogue has been educational for all participants. It has promoted a common understanding of ESG metrics that are credit-relevant and has enabled them to start choosing those that should be disclosed as a baseline for credit analysis.
- **Materiality varies**, depending on sector, business model, company structure and size, as well as regulatory environment. An issuer's individual characteristics, financial strength and whether it is aware of, and prepared to address ESG factors, also impact whether the latter are evaluated as risks or opportunities.
- **Peer comparison remains challenging** as credit risk is measured on a relative scale. The quality and availability of issuer ESG data is patchy, despite listed corporates improving their disclosure of information.
- **E and S assessments are developing:** While governance factors remain the most relevant to credit risk, participants are increasingly discussing how to manage environmental and social issues.

In addition, two other themes were repeatedly brought up:

- There is confusion among investors between credit and ESG ratings.[2] To address this, we have built a webpage that clarifies the distinction between them, but investors still need to better understand what they measure and when they complement each other.
- The impact of certain environmental and social factors, such as climate change or biodiversity loss, on issuers' credit quality in the long term remains unclear, meaning that analysts need to increasingly rely on scenario analysis to inform their investment decisions.

We will continue to promote engagement between investors, CRAs and issuers to enhance transparency and address misconceptions, and will look at how to further expand the initiative to address these outstanding challenges.

1 This extensive engagement included a series of workshops, complemented by panel and webinar discussions. These informed articles, podcasts and other resources, available at www.unpri.org/credit-ratings.

2 Some CRAs have started producing ESG ratings (also called ESG scores, or ESG evaluations) that are separate to their credit risk assessments.

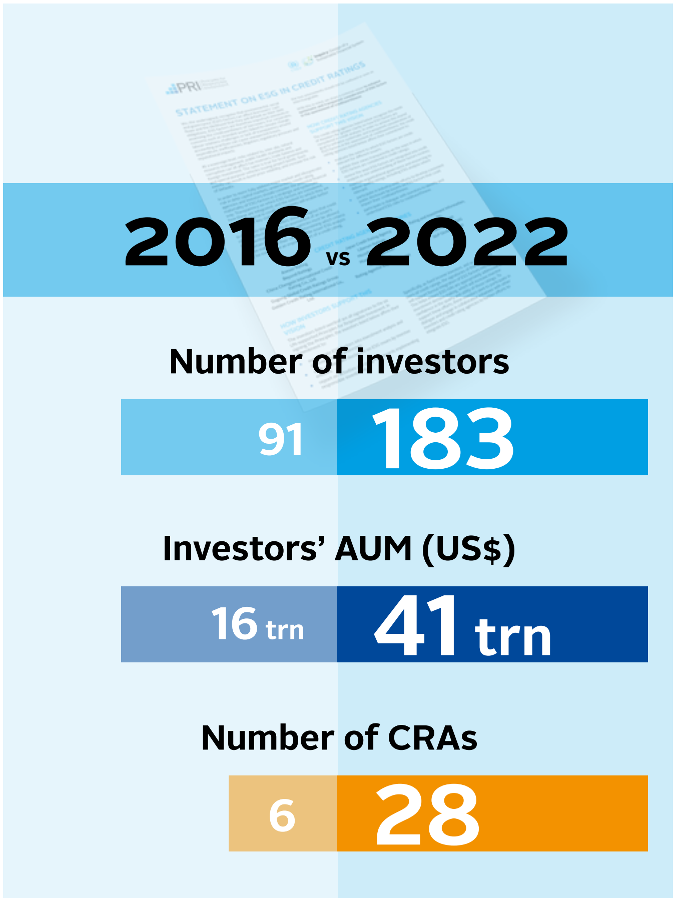
THE GROWTH OF THE INITIATIVE

This section highlights how the initiative has grown and provides some context for the work undertaken during the second phase.

The PRI has been working with investors and CRAs through the ESG in Credit Risk and Ratings Initiative to promote a more systematic and transparent incorporation of ESG factors in credit risk assessments since 2016 and commenced the second phase in 2020.

As of 31 December 2022, 183 investors with over US$40 trillion of assets under management (AUM) and 28 CRAs support the initiative. The range of investors and CRAs that have signed the [ESG in Credit Risk and Ratings Statement](#) is very broad and diversified globally, and the continued growth of supporters is a testament to the importance of this topic.

Figure 1: Signatories to the ESG in Credit Risk and Ratings Statement



The uptake by CRAs has been equally remarkable, growing from 6 in 2016, to 18 in 2019 and 28 in 2022. Indeed, the initiative is supported by the industry's three largest CRAs (Fitch Ratings, Moody's Investor Service and S&P Global Ratings), alongside regional and specialised ones that differ in size and resources.

As such, the extent to which they are incorporating ESG factors more explicitly in their methodologies, analysis and credit risk assessments varies. Regardless of these differences, they are all working towards the same goal in keeping with their commitments to the initiative.

Figure 2: CRAs supporting the ESG in Credit Risk and Ratings Initiative

FOUNDING SIGNATORIES (6):

- Dagong Global Credit Ratings Group
- Liberum Ratings
- Moody's Investors Service
- RAM Ratings
- Scope Ratings
- S&P Global Ratings

CURRENT SIGNATORIES (28):

- Dagong Global Credit Ratings Group (May 2016)
- Liberum Ratings (May 2016)
- Moody's Investors Service (May 2016)
- RAM Ratings (May 2016)
- Scope Ratings (May 2016)
- S&P Global Ratings (May 2016)
- China Chengxin Credit Management Co., Ltd (Nov 2016)
- Golden Credit Rating International Co., Ltd (Nov 2016)
- Rating-Agentur Expert RA GmbH (June 2017)
- Axesor Rating (Aug 2017) – now part of EthiFinance
- Japan Credit Rating Agency (Sep 2017)
- MicroFinanza Rating (Nov 2017)
- Rating and Investment Information, Inc (Nov 2017)
- Spread Ratings (Jan 2018) – now part of EthiFinance
- JCR Eurasia Rating (May 2018)
- Fitch Group (Aug 2018)
- Fedafin AG (Aug 2018)
- Cerved Rating Agency (Apr 2019)
- Kroll Bond Rating Agency (Apr 2019)
- Pacific Credit Rating (Jan 2020)
- Nordic Credit Rating (Apr 2020)
- HR Ratings (Jan 2021)
- DBRS Morningstar (Mar 2021)
- Acuite Ratings & Research (Sep 2021)
- Creditreform Rating AG (Sep 2021)
- Islamic International Rating Agency (Jan 2022)
- Calificadora de Riesgos Summaratings S.A. (July 2022)
- Bells & Bayes Rating Analytics (Dec 2022)

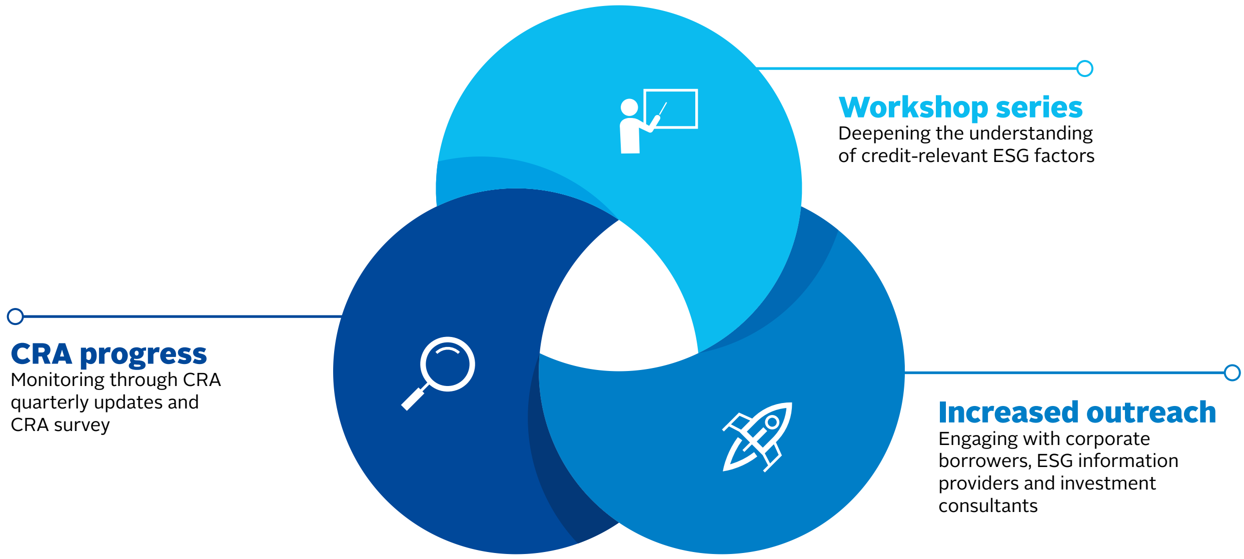
2016 **2022**

In 2019, we released a set of recommendations for CRAs and investors to start addressing the disconnects we identified at the start of the initiative (i.e. on ESG materiality, credit-relevant time horizons, how investors approach ESG incorporation, and transparency and communication). These have informed our work during phase two, as highlighted in Figure 4.

Figure 3: Phase one recommendations

CRAS	INVESTORS AND CRAs	INVESTORS
▪ Map ESG credit-relevant factors and flag triggers that could alter medium to long-term assessments ▪ Improve ESG factor signposting and be more explicit in commentaries ▪ Increase outreach on ESG topics	▪ Categorise ESG factors by type, relevance and urgency ▪ Conduct regular retrospective analysis and assess the evolution of ESG consideration ▪ Recognise credit-relevant time horizons ▪ Provide analysts with ongoing training ▪ Engage with issuers on ESG topics ▪ Improve disclosure and transparency	▪ Set up internal frameworks to make ESG consideration more systematic ▪ Do not confuse the purpose of credit ratings and ESG assessment services ▪ Be more proactive with issuers, service providers and in public consultations

Figure 4: Three areas of work during the second phase



LESSONS LEARNT FROM ISSUER ENGAGEMENT

This section summarises the main conclusions drawn from a series of workshops designed to improve issuers' ESG disclosures and to encourage a dialogue between issuers and credit analysts.

To explore how ESG considerations vary across debt instruments, improve the way companies disclose credit-relevant ESG data and create an opportunity for credit analysts and issuers to interact with each other, we hosted a series of workshops.

We convened credit analysts from fixed income investors and CRAs alongside issuer representatives, such as chief financial officers (CFOs) or heads of treasury, as well as chief sustainability officers. The workshops looked at investment grade and high-yield issuers from different geographies and sectors.

A full list of participating organisations can be found in Appendix 1.

Figure 5: Workshop participants

Workshop sectors
Banking
Chemicals
Debt Repurchasing
Facility Management
Food Value Chain
Healthcare
Industrials
Insurance
Mining
Oil & Gas
Paper & Packaging
Pharmaceuticals
Real Estate
Rental Equipment
Shipping
Tech/Software
Transport
Towers/Infrastructure
Telecoms
Utilities

The purpose of the workshop series was to:

- promote consensus around credit-relevant ESG issues for corporate borrowers;
- align expectations around ESG disclosures; and
- improve communication between credit analysts and issuers.

The conversations were framed around the three pillars presented in Figure 6 and were guided by talking points we prepared in advance (see example in Appendix 2).

Figure 6: Areas of focus when considering credit-relevant ESG factors. Source: PRI, based on a resource from the Société Française des Analystes Financiers (SFAF)/European Federation of Financial Analysts Societies (EFFAS).

A. SUSTAINABILITY OF BUSINESS MODELS	B. FINANCIAL IMPACT OF ESG RISKS AND OPPORTUNITIES	C. ISSUER ENGAGEMENT
Mapping materiality ESG challenges and megatrends affecting business sustainability	**Accounting disclosure** Revenues & Costs Expenditures Assets & Liabilities Capital & Financing	**Access by credit analysts to management** Appropriate person and/or department to engage with
Preparedness Adaptation of business model to challenges Assessment of strategic decisions Appropriateness of company resources	**Other areas** Operational strategy Financial strategy Market positioning Corporate structure	**Disclosure and transparency** Corporate structure Relevant covenants Taxes

The main conclusions from the discussions are summarised on the next page.

> "The event went into more depth than I expected (and certainly more so than others I have attended), as the conversation moved from high-level considerations to more involved ones."
>
> Issuer participant

FINANCIAL MATERIALITY DEPENDS ON FACTOR

The financial materiality of ESG factors is a critical component of credit risk assessment, although investors still struggle to determine what affects issuers' probability of default the most.

The workshop discussions highlighted that financial materiality can differ depending on many factors.

Figure 7: Factors affecting the materiality of ESG issues for credit risk

SECTOR	For example, companies in the food sector shared that they pay particular attention to deforestation and need complete oversight of their value chains, while banks focus more on ESG issues related to litigation and human resources.
GEOGRAPHY	Some ESG issues, such as those related to diversity, equity and inclusion, appear more credit-relevant in certain geographies than others.
BUSINESS MODEL	For example, in the telecoms industry, a company might consider ESG factors differently depending on whether it builds infrastructure or operates networks.
VALUE CHAIN POSITION	Some issuers provide services or products that are intermediate components in a broader value chain and can contribute to the low-carbon economy transition – chemical companies, for example. In such cases, investors need to consider the potential negative impact of some ESG factors against the positive contribution of others in determining how financially material they are.
TIME HORIZON	For example, climate-related issues, such as reaching carbon neutrality by 2050, are unlikely to affect the risk assessment of a five-year bond. Factors can become more or less material over time and credit analysts must reflect this in their assessments.
STAKEHOLDER PERCEPTION	Companies, investors, CRAs and other stakeholders (e.g., regulators, clients) may not always agree on what constitutes material information. For example, participants from the mining sector identified water as a material issue but said they faced demands from some investors to prioritise disclosing information on greenhouse gas emissions.

> "It was very interesting to hear views of different stakeholders [on] this topic, and I particularly liked to hear companies asking so many questions."
>
> Investor participant

GOVERNANCE REMAINS KEY

Governance has traditionally been regarded as most material to credit risk and has been extensively incorporated into credit rating models and valuations for corporate bonds.

In addition to typical metrics (such as the composition and independence of boards, the frequency of its meetings and the track record of the company strategy), analysts explained during the workshops that they are now considering some new key performance indicators (KPIs). These include:

- board diversity;
- accountability for sustainability strategies (including clear management functions and responsibilities, checks and controls);
- transparency (for instance on procurements); and
- corporate culture.

Participants also emphasised considering a company's ownership structure, as it can impact the transparency and time horizon of its business strategy, its internal culture, use of leverage and remuneration policies – factors that are important when assessing governance.

Credit analysts shared that they regularly use information such as a company's board composition to assess its complexity. Family-owned companies tend to be more flexible and faster in making decisions. They can also be more open to taking medium- and long-term risks and are not impacted by the short-term share price dynamics that affect listed companies. However, they can be less transparent.

During the workshops, investors encouraged issuers to be more transparent and to credibly demonstrate how they address ESG issues in their operations. They can do this by providing education and training across their organisations, so that employees understand how sustainability is embedded in their daily activities. One insurance company has started doing this by introducing ESG-linked KPIs and incentives for all employees.

E, S AND G FACTORS ARE TIGHTLY LINKED

Investors, CRAs and issuers are increasingly aware that E, S and G issues are interlinked, and should not be considered in isolation. For example, they are concerned about the social and economic costs of a low-carbon transition and the potential conflict between climate and societal goals if such a transition is not just and inclusive.[3]

This was particularly prevalent when workshop participants discussed the exposure of insurance companies to climate change risks. While insurers could stop providing coverage for wildfires, for example, to reduce their balance sheet exposure to such risks, this would not reduce the risk itself.

Furthermore, failing to protect people and businesses dealing with increasingly frequent wildfires (due to climate change) could lead to reputational damage – a risk that could become financially material.[4] It would also run counter to the principles of financial inclusion and a just transition, such as ensuring that individuals and companies have access to enough resources to make the necessary changes to their businesses.

According to CRAs, companies that can, instead, capitalise on the opportunities presented by this challenge, such as developing new products or using innovative strategies to better manage their risks, will stand out to credit analysts and may, as a result, receive higher ratings.

To summarise, while materiality differs across sectors and companies, the overall links between ESG factors and credit risk require further work from companies and analysts to better understand which data, KPIs and metrics are needed in addition to the ones traditionally used for financial analysis.

DATA AVAILABILITY AND QUALITY ARE STILL CHALLENGING

Good data allows investors to make informed investment decisions, CRAs to better assess issuers' probability of default and companies to build efficient businesses. However, our workshop discussions confirmed that the availability, quality, reliability and consistency of data is a perennial problem.

Investors and CRAs struggle to access relevant data and – where it exists – its coverage is limited, often outdated, or incomparable between sectors and companies.

3 For more information on the concept of a just transition, see, for example, Inevitable Policy Response (2019) Why a just transition is crucial for effective climate action.

4 For more information, see the PRI's Insurance workshop summary.

This can partly be explained by the plethora of reporting standards and frameworks (e.g., Sustainability Accounting Standards Board (SASB), Task Force on Climate-Related Financial Disclosures TCFD), Global Reporting Initiative (GRI)) that all require different information. For issuers, having to report on these and respond to many requests from investors, CRAs and ESG information providers can be a time-consuming burden.

The workshop discussions emphasised that striking a balance between disclosure and resource allocation was important.

Companies and investors both expressed frustration with ESG information providers: on the significant number of information requests and sometimes seemingly arbitrary scoring, and the lack of focus on financial materiality and equity bias, respectively.

Consequently, investors with the resources to do so said they preferred to assess issuers using raw data, rather than ESG ratings from providers.

Credit analysts want standardised, comparable information but also need to recognise the circumstances and challenges that companies face around disclosure, depending on their ownership structure and size.

Larger listed issuers tend to have more resources to dedicate to collecting, computing and sharing ESG data than smaller private issuers. Investors might also find it more difficult to access information from these companies (prevalent among high-yield issuers) as they are not subject to the same reporting requirements as public entities.

Workshop participants agreed that they need better and more standardised disclosure on ESG topics from issuers, with more effective channels of dissemination. They pointed to the International Sustainability Standards Board, a new standard-setting board, as potentially being able to deliver that data standardisation.

MORE ENGAGEMENT NEEDED TO IMPROVE COMMUNICATION

Active communication between credit analysts (at investor organisations and CRAs) and companies' CFOs or treasury departments is important:

- for borrowers to better explain how they operate, what ESG factors they consider and how they prioritise which data to disclose;
- for analysts to better understand how ESG materiality varies by sector and company and to educate issuers about why their ESG-related requests are increasing, particularly in light of regulatory changes.

Efficient engagement between credit analysts and issuers should serve to identify and facilitate a better exchange of information.

The workshops highlighted that while companies' corporate finance staff, i.e. CFOs or heads of treasury, interact with CRAs on a regular basis, they have fewer opportunities to meet with fixed income portfolio managers and credit analysts, as company engagement is more commonly done with equity investors.

Furthermore, investors feel that companies communicate financial metrics (including material ESG data) primarily to respond to shareholder queries, and that the information is typically not geared towards their needs.

Consequently, some investors say that they rely on CRA data for certain aspects of their analysis.

Relying on reported data is not enough, participants agreed. Face-to-face meetings are important to make sure that the information disclosed is reliable and backed by concrete actions, therefore minimising the possibility of greenwashing.

Investors welcomed the idea of issuers organising specific conferences or management meetings targeting bondholders, while joint engagement, involving equity and fixed income investors from the same organisations, was also highlighted.

Finally, additional stakeholders such as company advisors (lawyers, sell-side originators, debt capital market desks etc.) should also be involved in these conversations to make ESG disclosure more transparent and to disseminate ESG data more effectively.

> "Many of the points raised [cover] pretty complex topics and will require work over time; a continuation of such workshops under the – neutral – helmet of PRI is very important in my opinion."
>
> CRA participant

PROGRESS MADE BY CRAs

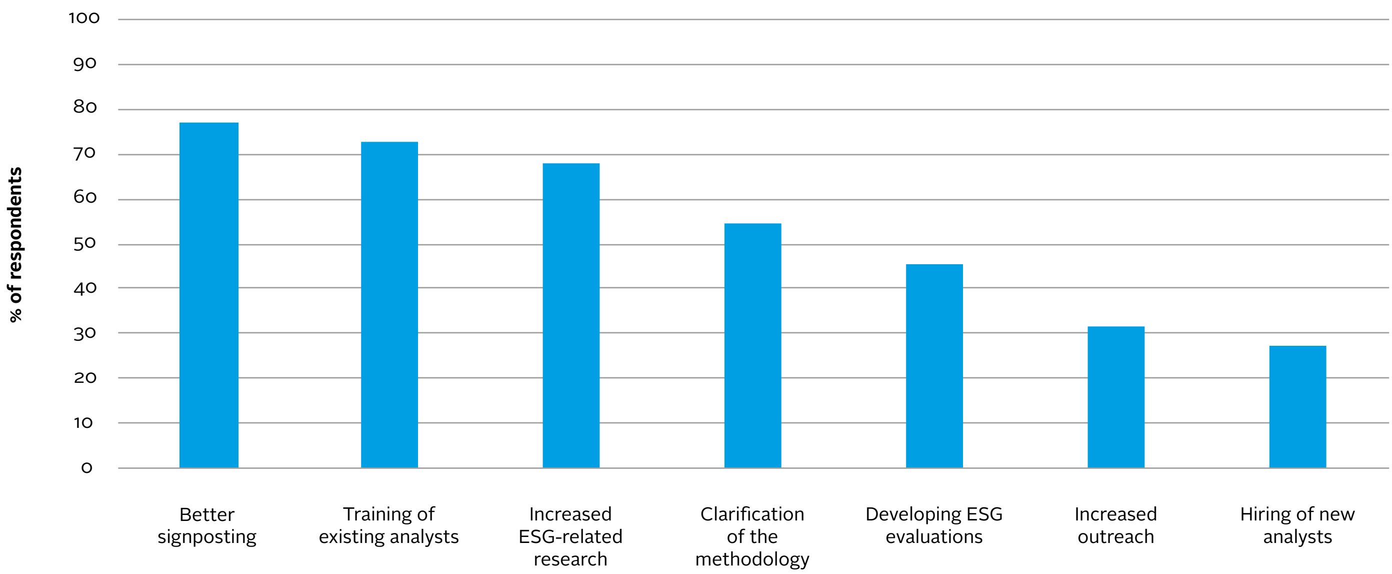
This section summarises how CRAs have developed – across their credit analysis, organisation, communication and transparency – and highlights the progress they have made and the challenges that still need to be addressed.

To understand the impact the initiative has had on participating CRAs, we surveyed the supporting organisations. Of the 22 CRAs that responded, 91% found that joining the initiative has improved how they incorporate ESG factors in their credit risk assessments, helping them do so more transparently and systematically.

Overall, CRAs have improved in several ways, including:

- better identifying and showcasing the impact of ESG issues in their analyses and ratings;
- expanding and dedicating resources to build ESG teams, train or hire analysts and develop analytical tools; and
- broadening their outreach to relevant stakeholders, including rated entities, investors, regulators and ESG information providers.

Figure 8: Changes made since the initiative launched*



*Respondents could select multiple answers

CREDIT ANALYSIS

Since the initiative started, and especially in the last few years, the realisation that some ESG issues can present systemic risks to financial markets and should be embedded in their assessment of issuers has grown.

Research clarifying the credit-relevance of ESG factors and themes has increased. Almost half of the responding CRAs now include dedicated sections that discuss the ESG risks and opportunities to an issuer's credit profile in their credit rating opinions.

Five percent conduct separate ESG discussions as part of their rating committees, while 18% explain how they integrate ESG considerations in their methodologies. Nonetheless, almost a quarter of CRAs have not made any changes to the way they conduct credit risk assessment.

The majority of CRAs admit that regulatory requirements have also played a role in them making ESG factors more transparent and systematic in credit risk analysis, with 82% indicating that the strongest pressure has come from the European Union.

The European Securities and Markets Authority's technical advice and guidelines on sustainability considerations in credit ratings have helped guide CRAs' ESG disclosures in press releases and reports. Since March 2020, CRAs operating in the EU have had to disclose whether ESG factors were a key driver behind a change to a credit rating or rating outlook.

In markets where the regulation is less binding (or sometimes non-existent), such as Asia and Central and South America, CRA respondents observed that they are being pushed by the market to consider ESG factors more systematically, with many investors and issuers starting to request better practices of them.

Figure 9: Changes to credit risk assessment process

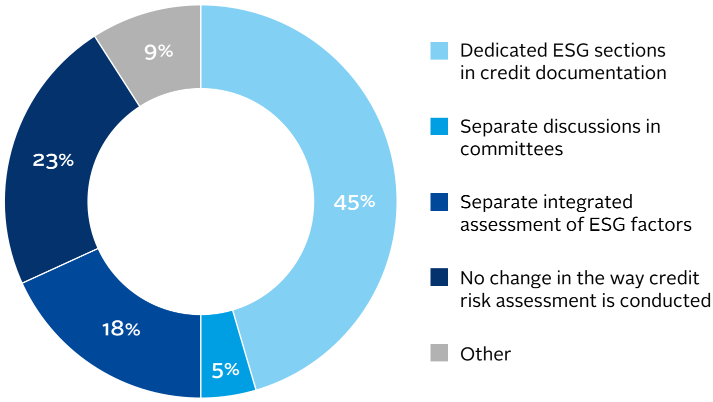


Figure 10: Impact of regulation on use of ESG factors

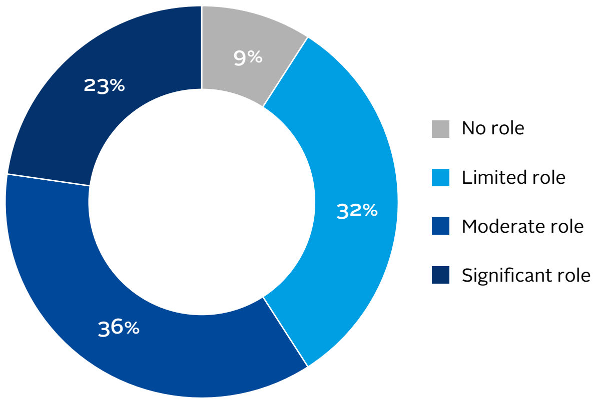
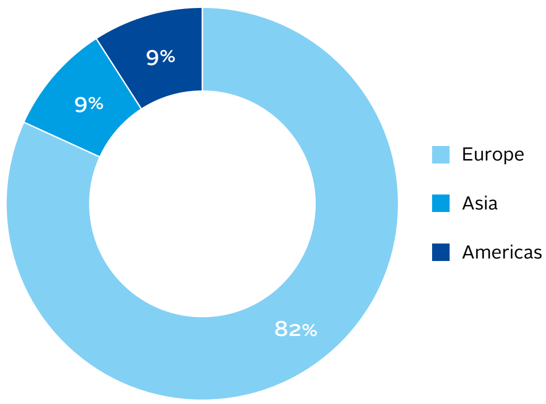


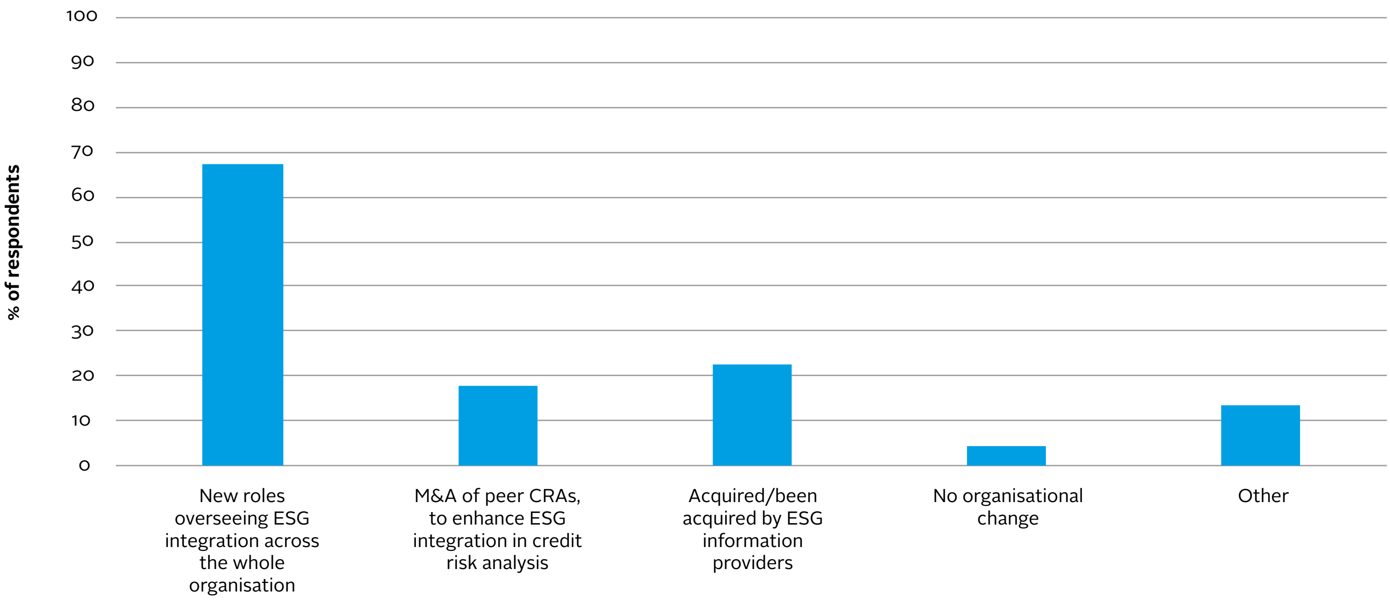
Figure 11: Where regulatory pressure is coming from



ORGANISATIONAL CHANGES

CRAs have significantly improved their tools and resources over the last three years. Just over two-thirds have created new roles to oversee ESG incorporation across their organisations, while 41% have increased their ESG capabilities by acquiring or merging with an ESG information provider or peer.

Figure 12: Organisational changes made*

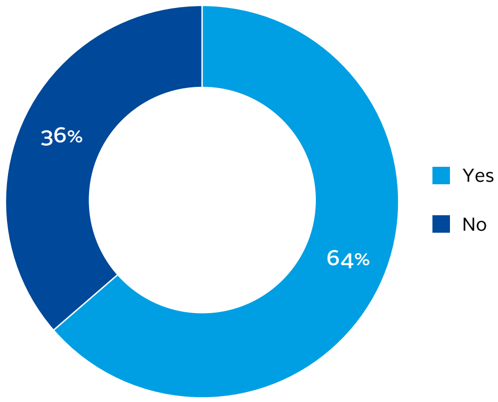


*Respondents could select multiple answers

Alongside this market consolidation, CRAs have expanded their offerings – 64% now produce ESG ratings that are separate to their credit risk assessments, for example.

While this reflects their efforts to more explicitly highlight how ESG factors impact credit rating opinions, it has also contributed to confusion among market participants about what ESG ratings measure, how they should be interpreted and how they differ from credit ratings. Even if different departments (and sometimes, legal entities) are responsible for producing these indicators, the distinction between them remains unclear to many investors.

Figure 13: ESG ratings produced



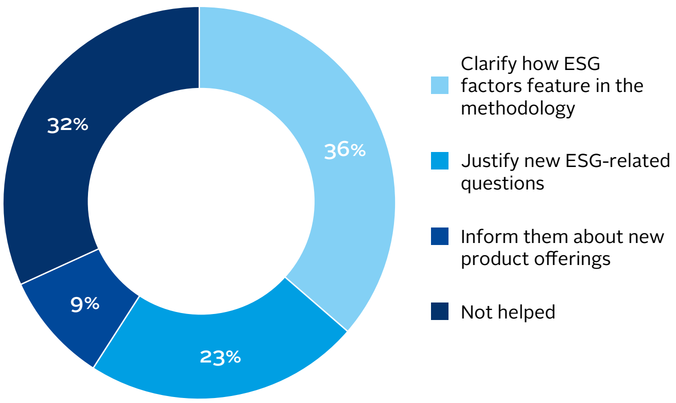
COMMUNICATION AND TRANSPARENCY

Communication and transparency around ESG topics were limited at the start of the initiative and consequently, at the end of the first phase, we recommended that CRAs enhance their outreach on ESG topics.[5]

CRAs say that taking part in this initiative has helped them to:

- clarify how sustainability issues feature in their methodologies (36%);
- justify the new ESG-related questions they ask issuers (23%); and
- inform issuers or clients about new product offerings (9%).

Figure 14: Role of initiative in helping CRAs increase their ESG outreach to rated entities



As regulated organisations, CRAs should remain independent when assessing rated entities, to avoid any conflict of interest.[6] However, they can discuss relevant topics with issuers, and can assess financially material ESG factors to determine how they impact issuer creditworthiness. In addition to justifying new ESG-related questions, because of their participation in the initiative, the survey results show that CRAs have such conversations with rated entities more often (see also Figure 8, pg. 14).

Almost 70% of CRAs have launched dedicated ESG platforms and webpages, to disseminate ESG-related reports, events and methodology information. Nearly all these pages (80%) are freely accessible.

To inform investors and other stakeholders of these developments, we launched a comprehensive resource outlining CRAs' latest ESG-related activities at the beginning of 2020. The quarterly update compiles:

- research reports related to credit-relevant ESG considerations;
- a selection of CRA opinions that have been driven by ESG factors or that contain a dedicated ESG paragraph;
- events focused on ESG factors and credit risk organised by CRAs or in which they have participated;
- information related to how CRAs incorporate ESG factors into their credit rating methodologies.

REMAINING CHALLENGES

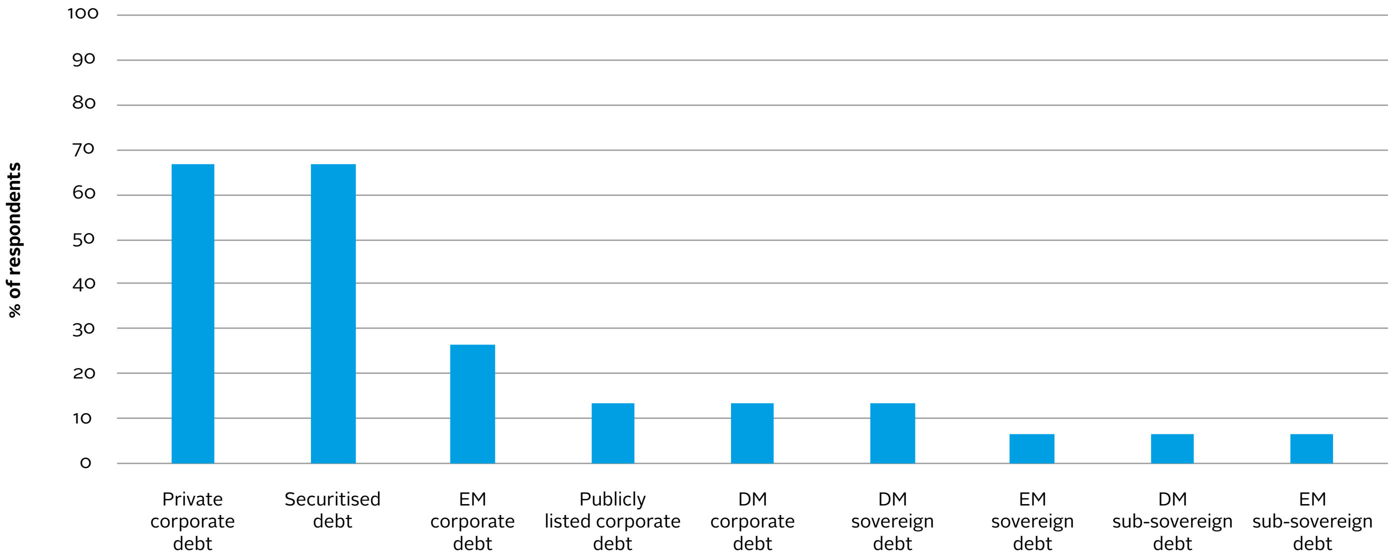
Despite the significant progress made by CRAs in maintaining their commitment to the initiative, 86% say they still face some persistent challenges to incorporating ESG factors in credit risk assessment.

The main obstacle is data, whether limited issuer disclosure on credit-relevant ESG information (59% of CRAs) or a lack of historical data on how ESG factors impact the performance of ratings (14%). CRAs are limited in the assessments they can conduct and how easily they can compare year-on-year or peer issuer data.

More than two-thirds of those CRAs also have difficulty incorporating ESG factors in their ratings for certain types of fixed income instruments, especially private and securitised debt[7] – two complex categories for which disclosure is the most limited.

5 See PRI (2018) Shifting perceptions: ESG, Credit Risk and Ratings – Part 3: From disconnects to action areas.
6 ESMA's CRA Regulation in the EU and SEC's Dodd Frank Act in the US.
7 For resources focused on these areas of fixed income, see www.unpri.org/investment-tools/fixed-income.

Figure 15: Most challenging asset classes for ESG incorporation in credit ratings*



*Respondents could select multiple answers

Almost a quarter of participants also struggle with modelling the uncertainty and/or visibility of ESG risks. CRAs cannot assess ESG risks whose impact may go beyond the typical time horizon that most credit rating opinions are based on. Indeed, the further these extend into the future, the more uncertain they become.

This is problematic for investors that require credit-relevant information linked to long-term ESG trends, such as climate change.

Due to this disconnect, investors insist on CRAs extending the forward-looking component of their credit opinions. Some agencies have started lengthening the time horizons they use in their scenario analysis[8], for example, but a lot more work needs to be done to address this.

Read the latest CRA quarterly update

8 See the webinar discussions on lengthening time horizons, modelling uncertainty in credit risk and choosing credit-relevant time horizons.

ENGAGING ESG INFORMATION PROVIDERS AND INVESTMENT CONSULTANTS

This section outlines the results of our engagement, through surveys and conversations, with other stakeholders that support investors with their credit risk assessment and ESG incorporation.

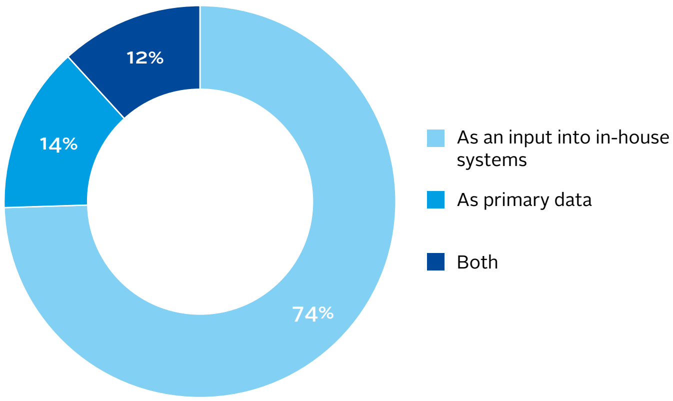
ESG INFORMATION PROVIDERS

Fixed income investors increasingly use a range of ESG data and information, beyond traditional financial metrics, to make investment decisions, and ESG information providers play a key role in aggregating and analysing this data from issuers.

To understand how fixed income investors use ESG information providers, we surveyed 59 asset owners and investment manager signatories in 2020.

Three-quarters of respondents used third-party ESG resources as an input into their proprietary ESG assessments, rather than using them as primary ESG data without conducting internal analysis. This suggests that fixed income investors are becoming more sophisticated, by building their own ESG research and analytical systems, for example.

Figure 16: Investor uses of third-party ESG resources



Most investors said they were satisfied with ESG information providers' products and services related to developed markets, investment grade corporate and financial sector issuers, but that there were major gaps for all other issuer types.

These included high-yield and emerging market corporates, leveraged loans, private debt issuers, US municipal bonds, and structured products.

Following this survey, we engaged with 20 ESG information providers, grouped in six categories: large providers, those acquired by CRAs, climate specialists, controversy specialists, data specialists and sovereign specialists.

We wanted to:

- better understand how useful third-party data and product offerings are for fixed income investors and where they need to improve; and
- clarify how their methodologies differ from those of CRAs and how transparent they are.

Providers have been trying to make their products more relevant to debt instruments in recent years – having been historically tailored to meet the needs of equity investors. They acknowledged that significant gaps remain and intend to address these.

Their products do not reflect the complexity of fixed income instruments, which differ in credit quality, duration and characteristics, or their issuers (corporate, sovereign, and sub-sovereign).

Furthermore, the underlying methodologies behind their assessments lack transparency – such as which ESG factors are assessed, and the weightings they assign to them.

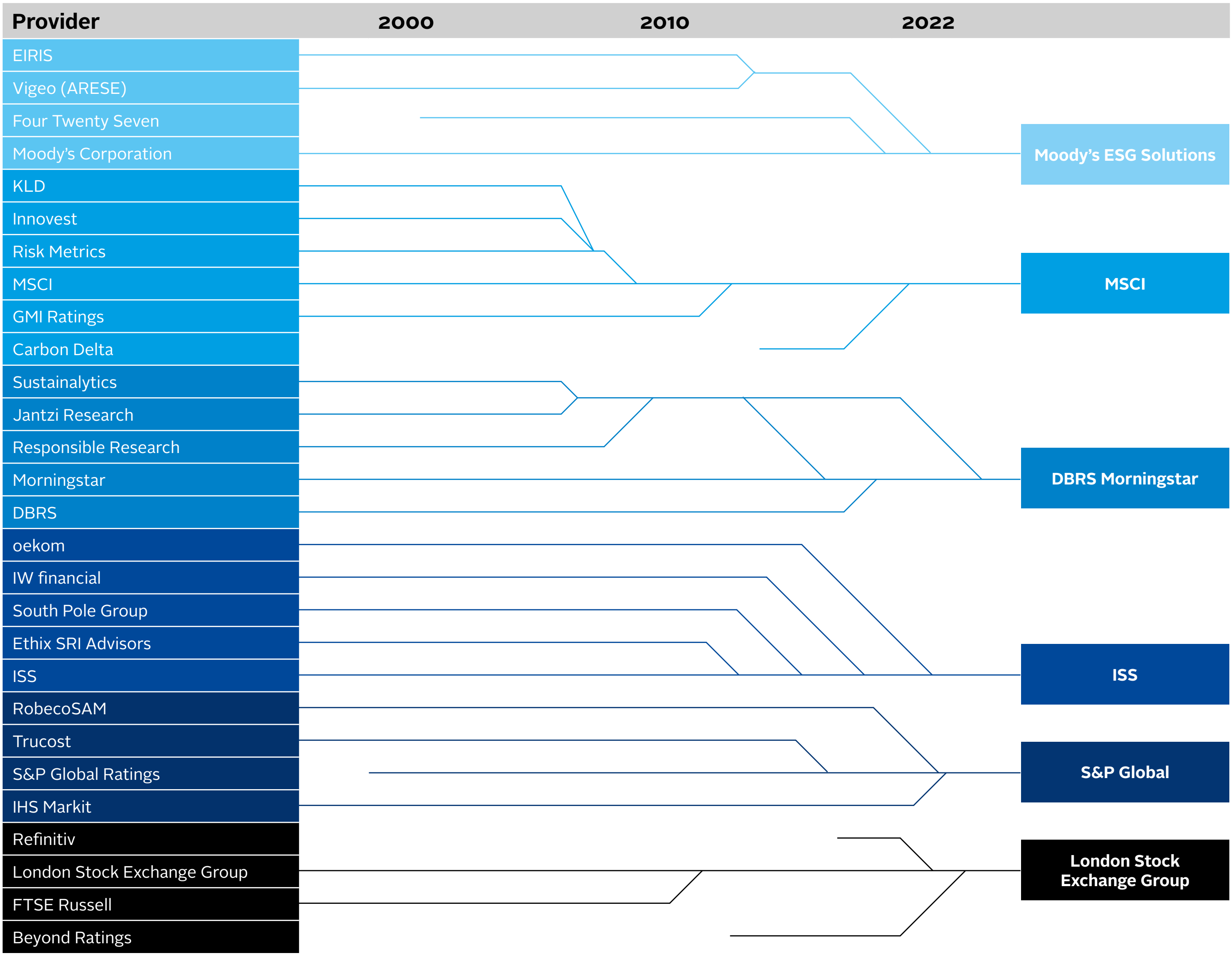
This has significant implications for portfolio construction and asset allocation and is reflective of wider challenges the responsible investment industry faces in having consistent, reliable, and comparable ESG data – a crucial component of developing a sustainable financial system.

As explained in Progress made by CRAs, ESG ratings and credit ratings are distinct but complementary products, and market participants have expressed confusion about what the former measure, among other things, often because some of the issues that they capture overlap.

Moreover, this confusion has increased further due to M&A activity in the sector, with some CRAs buying ESG information providers (and offering both credit and ESG ratings) and vice versa.

In light of this ongoing market consolidation, we have created a publicly accessible webpage, mapping the products that ESG information providers offer, what they measure, and how this differs from their credit ratings.

Figure 17: ESG information provider market consolidation between 2000 and 2022. Source: See footnote[9]



Updated by the PRI in 2022.

Ultimately, it is the responsibility of investors to choose and interpret the relevant ESG information and incorporate it in their investment decisions.

This task is not easy, in the absence of standardised data and with multiple issuer reporting frameworks – such as the GRI, CDP, SASB or TCFD.

We have discussed the issue of standardisation (or the lack thereof) extensively in our workshops convening investors, CRAs and corporate debt issuers, as highlighted in Lessons learnt from issuer engagement.

Read the full engagement findings:
Do ESG information providers meet the needs of fixed income investors?

9 Andreas Dimmelmeier (2020) Mergers and Acquisitions of ESG Firms: Towards a New Financial Infrastructure?

INVESTMENT CONSULTANTS

We engaged with investment consultants as they are critical stakeholders in the investment chain, advising institutional asset owners on a range of issues, including the selection, appointment and monitoring of external managers.

They can play a key role in supporting asset owners[10] to develop responsible investment practices, and to assess their investment managers' ESG incorporation and stewardship approaches.

We surveyed 31 asset owners and 15 investment consultants to understand how:

- asset owners use investment consultants to select, appoint and monitor their external fixed income managers;
- asset owners view the ESG-related fixed income advisory services that consultants provide;
- investment consultants assess the ESG incorporation practices of external fixed income managers, and rate their level of expertise in doing so; and
- aligned both parties are on the materiality of ESG factors in various fixed income sub-asset classes.

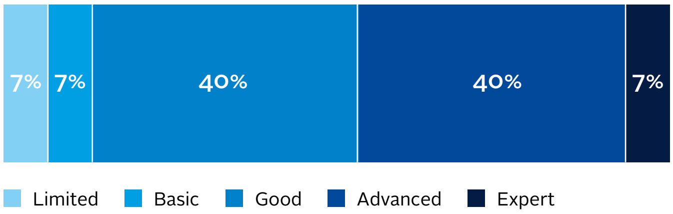
We found that although many investment consultants have dedicated ESG resources and are developing ESG questionnaires for investment managers, they are often generic or focused on equities, where responsible investment practices are more advanced.

As such, investment consultants must adjust their due diligence processes to better meet clients' fixed income needs, including:

- improving their communication with the investment managers they assess;
- strengthening their initial and follow-up ESG assessments; and
- expanding their fixed income ESG coverage across instruments, strategies and geographies.

Although asset owners were satisfied with the ESG knowledge level of their investment consultants, providing them with more guidance on their ESG policies and investment objectives could help improve the services they receive.

Figure 18: Investment consultants' ESG knowledge in fixed income according to asset owners



Both groups recognise the importance of ESG factors for fixed income assets, but they need to better understand how material ESG factors are for bond risk assessment, especially credit risk.

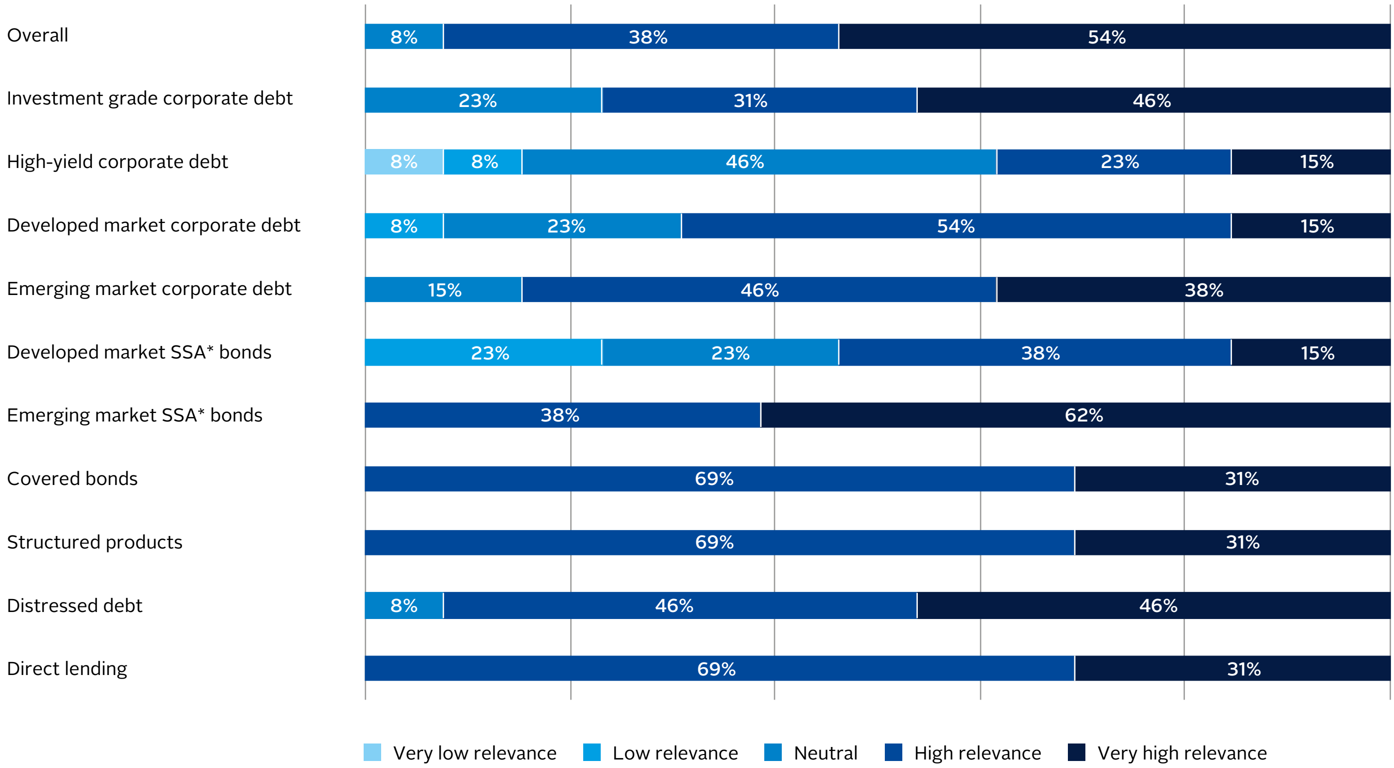
They also need to take a more nuanced approach to assessing bondholder engagement, which – although different from shareholder engagement – can help fixed income investors make more informed decisions and fulfil their duties as responsible stewards of capital.

Although investment consultants have been making significant efforts over the past few years to consider ESG factors more systematically in their manager analysis, a lot more work lies ahead – especially for fixed income assets.

They need to adjust their organisational approaches to better reflect ESG considerations, making sure that these issues are embedded at all staff and activity levels. Ultimately, asset owners need to ensure the services they receive from their consultants align with their own investment strategies and objectives.

10 For more information on the PRI's work on asset owners and investment consultants, see our asset owner resources.

Figure 19: Relevance of ESG considerations in fixed income for asset owners and investment consultants (aggregated)



*Sovereign, supranational or agency

Read the full survey findings:
[Broadening the outreach to investment consultants]

CONCLUSION

Although the ESG in Credit Risk and Ratings Initiative has come a long way since its launch, there still needs to be more awareness and understanding of how CRAs have adapted to better signpost and systematically incorporate ESG factors into their analysis.

As investors and borrowers are also trying to enhance the risk assessment of their investment decisions and business models, respectively, the workshop series revealed that deepening the understanding of when ESG factors are material and how they impact credit risk requires more stakeholder collaboration and engagement.

Continuing this investor-CRA-borrower dialogue is key to creating a shared understanding of credit-relevant ESG factors, building a common language and recognising shared challenges, especially as ESG issues and their salience evolve. Participants should prioritise developing a common set of standard ESG metrics.

During the second phase of the initiative our focus has largely been on the credit risk of corporate borrowers and we have taken a sectoral approach. Going forward, we intend to:

- expand our focus to public finance and structured products;
- gain a better understanding of how credit-relevant time horizons vary; and
- take a thematic approach to explore how specific ESG issues impact credit risk and metrics.

On the latter point, for climate-related risks, for example, the market is starting to look at the cost of asset or collateral impairment caused by extreme climate events. There is much less focus on how emission-curbing measures – required for the transition to a low-carbon economy – impact issuer balance sheets.

Transitioning towards more sustainable business and growth models, whether to adjust to new trends or regulatory developments, requires issuers to make changes that can create near-term costs and a temporary decline in credit quality. In contrast, the associated benefits – including financial savings – may only become apparent over a longer period, and while their credit ratings may recover, issuers are not always rewarded for becoming more resilient to ESG risks.

To address this mismatch, credit analysts should assess issuers' long-term prospects, rather than their short-term performance. At the same time, issuers should improve how they communicate their strategic planning and disclose relevant data, so that credit analysts can better understand and monitor their sustainability trajectories. This will inform our work going forward.

Finally, we also aim to diversify our work by region, in response to the growing PRI signatory base and because ESG attributes and the financial strength of issuers to address them can vary by geography.

By leveraging the PRI's convening power, the initiative will continue to provide a forum for fixed income investors, for whom credit remains a primary concern, to enhance risk assessment, unmask unpriced factors and reward issuers with sustainable business and growth models.

APPENDIX 1: WORKSHOP PARTICIPANTS

COMPANIES		
ADM	EG Group	Nouryon
Air France KLM	Eir	OCI
Almaviva	ENEL	Orbia
Amer Sports	Engie	Orior
Anacap	ERT	Petkim/SOCAR
Anaqua	Ethypharm	Rio Tinto
Anglo American	Exact	Roehm (Madrid)
Arrow Global	Expocaccer	SABIC
Astorg	Fedrigoni	Sanofi
Atalian	Givaudan	Sappi
Atnahs	Groupe Credit Agricole	Sigma
Auchan	HSBC	Sime Darby Plantations
Bank of America	Iberdrola	Sivantos/WS Audiology
Barclays	ICA	SNAM
Bayer	IGM Resins	SNF
Belfius	Ineos	Stada
BHP	Intrum	Standard Chartered
BMO	Ion	Syngenta
BRF	iQera	Synthomer
Bunge	KBC	TalkTalk
Cabot Financial	Klépierre	TDC
CaixaBank	Lanxess	TeleColumbus
Cargill	Legal & General	Terna
Casino	Liberty Global	Thames Water
Cellnex	Loxam	Tideway
Citi	M&G	TK Elevator
CMA CGM	Masmovil	Total
Colisee	Maxeda	UBS
Danone	Mediq	UniCredit
Delachaux	Minerva Foods	Viterra
Deutsche Bank	Nationwide	Wells Fargo
Dupont	Newmont Corporation	Yara
EDF	Nordea	Zentiva

INVESTORS		
Aberdeen Standard	Credit Suisse	Moneda Asset Management
Alberta Investment Management Corporation	CVC Credit Partners	Morgan Stanley Investment Management
Alcentra	DDJ Capital Management	Muzinich & Co.
AllianceBernstein	East Coast Asset Management	Natixis
Allianz Global Investors	Egamo	Neuberger Berman
Amundi	ERAFP	Newton IM
APG Asset Management	Erste Asset Management	Ninety One
Apollo	ESG Portfolio Management	NN Investment Partners
Astorg	Federated Hermes	Nuveen Investments
Atlanticomnium SA	Fidelity	Oak Hill Advisors
Australian Ethical Investment	Five Arrows	Oaktree Capital Management
AXA Group	Franklin Templeton	OFI Asset Management
AXA Investment Managers	GAM Investments	Ohman
Bain Capital	Generali Insurance Asset Management	Ostrum AM
Barclays	Generali Investments	PGIM Fixed Income
Bardin Hill Loan Advisors	Groupama Asset Management	Pictet
Barings	GSO Capital Partners	PIMCO
Bayerische Versorgungskammer	Guggenheim Partners	PineBridge Investments
Blackstone	HSBC Global Asset Management	Polus Capital Management
BlueBay Asset Management	IFM Investors	Premier Miton Investors
BMO Global Asset Management	Insight Investment	Public Investment Corporation
BNP Paribas Asset Management	Invesco	QBE
Brandywine Global Investment	Itau Asset Management	QIC
Breckinridge Capital Advisors	ITCB	Rothschild & Co
Brown Advisory	Janus Henderson Investors	Saturna Capital
Calvert	JP Morgan Asset Management	Schroders
Candriam	Jupiter Asset Management	SCOR SE
Capital Four	Kepler Cheuvreux	SEB
Caisse des Depots et Consignations	KKR	SKY Harbor Capital Management
Christian Brothers Investment Services	La Française	Solventis
Church of England (The Church Commissioners)	Legal & General Investment Management	Swiss Life
Church of Sweden	Leith Wheeler	Swiss Life Asset Management
CIFC Asset Management	Lombard Odier Asset Management	Sycomore Asset Management
Credit Mutuel CIC	Lord Abbett	Tikehau Capital
CNP Assurances	M&G Investment Management	TPT
Colchester Global Investors	Makalani Management Company	Triodos Investment Management

INVESTORS (CONTINUED)		
Columbia Threadneedle	Man Group	UBS Asset Management
Conning	MEAG MUNICH ERGO Asset Management	Voya
Credit Agricole CIB	Mercy	Wellington Management
Credit Mutuel Asset Management	Mondrian Investment Partners Ltd	Zais Group

CRAs		
AM Best	Independent Credit View	Pacific Credit Rating
Cerved Rating Agency	KBRA	Qivalio
DBRS Morningstar	MicroFinanza Rating	RAEX Europe
fedafin	Moody's Investors Service	S&P Global Ratings
Fitch Ratings	National Rating Agency	Scope Ratings
HR Ratings de Mexico	Nordic Credit Rating	

OTHER ORGANISATIONS	
Alternative Investment Management Association	Loan Market Association
Association of Corporate Treasurers	Loan Syndications and Trading Association
Centre for Climate Finance and Investment, Imperial College Business School	Moore Foundation/New Venture Fund
European Leveraged Finance Association	Société Francaise des Analystes Financiers/European Federation of Financial Analysts Societies
FAIRR Initiative	World Business Council for Sustainable Development
Global Compact Network USA	World Economic Forum

APPENDIX 2: EXAMPLE OF DISCUSSION GUIDE

ENVIRONMENTAL ISSUES

The focus of environmental discussions should be on identifying disruptions that could materially affect a business or influence its main strategy.

Using a bottom-up approach, credit analysts should monitor the following material variables:

- **Resource consumption:** use of raw materials, water, energy, recycled resources
- **Environmental footprint:**
  - Process footprint: waste, water pollution, recycling, biodiversity, carbon footprint
  - Product & services footprint: product lifecycle, carbon footprint
- **Green innovation:** eco-design of new products and services, circular economy

Figure 20: Key risks and potential financial impacts. Source: PRI, based on SFAF/EFFAS.

KEY RISK	POTENTIAL FINANCIAL IMPACT
PHYSICAL CLIMATE **Acute:** ▪ Increased severity of extreme weather events such as cyclones and floods **Chronic:** ▪ Changes in precipitation patterns and extreme variability in weather patterns ▪ Rising mean temperatures ▪ Rising sea levels	▪ Reduced revenue from decreased production capacity (e.g., transport difficulties, supply chain interruptions) ▪ Reduced revenue and higher costs from negative impacts on workforce (e.g., health, safety, absenteeism) ▪ Write-offs and early retirement of existing assets (e.g., damage to property and assets in high-risk locations) ▪ Increased operating costs (e.g., water supply to cool nuclear and fossil fuel plants) ▪ Increased capital costs (e.g., damage to facilities) ▪ Reduced revenues from lower sales/output ▪ Increased insurance premiums and potential for reduced insurance availability on assets in high-risk locations
TECHNOLOGY ▪ Substitution of existing products and services with lower-emission options ▪ Unsuccessful investment in new technologies ▪ Costs to transition to lower-emission technology	▪ Write-offs and early retirement of existing assets ▪ Reduced demand for products and services ▪ R&D expenditures in new and alternative technologies ▪ Capital investments in technology development ▪ Cost to adopt/deploy new practices and processes

Figure 21: Key opportunities and potential financial impacts. Source: PRI, based on SFAF/EFFAS.

OPPORTUNITY	POTENTIAL FINANCIAL IMPACT
ENERGY SOURCES ▪ Use of lower-emission energy sources ▪ Use of supportive policy incentives ▪ Use of new technologies ▪ Participation in carbon market ▪ Shift toward decentralised energy generation	▪ Reduced operating costs (e.g., through more efficient and responsible business practices) ▪ Reduced exposure to future fossil fuel price increases ▪ Reduced exposure to greenhouse gas (GHG) emissions and therefore less sensitivity to changes in carbon costs ▪ Returns on investment in low-emission technology ▪ Increased capital availability (e.g., as more investors favour lower-emission producers) ▪ Reputational benefits resulting in increased demand for goods and services
RESOURCE EFFICIENCY ▪ Use of more efficient modes of transport ▪ Use of more efficient production and distribution processes ▪ Use of recycling ▪ Move to more efficient buildings ▪ Reduced water usage and consumption	▪ Reduced operating costs (e.g., through efficiency gains and cost reductions) ▪ Increased production capacity, resulting in increased revenues ▪ Increased value of fixed assets (e.g., highly rated energy efficient buildings) ▪ Benefits to workforce management and planning (e.g., improved health and safety, employee satisfaction) resulting in lower costs

Analysts should link disclosure with how financial and non-financial variables will be impacted (positively or negatively). It is key to reconcile the existing disclosures with the potential financial impact of risks and opportunities. For example, declining water or electricity consumption expressed in volumes should be linked to the electricity or water costs registered in the income statement.

ENGAGEMENT

One of the areas for engagement on environmental issues is to assess an issuer's compliance with existing regulatory requirements and its capacity to adapt to prospective changes, especially as clear energy transition targets are beginning to emerge. For example, analysts could ask:

- How does your company intend to contribute to the call by the Intergovernmental Panel on Climate Change (IPCC) to decrease GHG emissions by 40% in 2050?[11] What are the financial implications of the measures that you intend to adopt?
- How have you factored the current European Union climate and energy targets for 2030[12] into your business plan? What is the financial impact of complying with these requirements?

11 For more information, visit the Intergovernmental Panel on Climate Change website.

12 The EU 2030 climate and energy framework targets are: at least 40% cuts in GHG (from 1990 levels); at least 32% share for renewable energy; and at least 32.5% improvement in energy efficiency. The targets were approved in October 2014 and subsequently revised upwards for renewables and energy efficiency in 2018.

SOCIAL ISSUES

Material social risks depend on the size of the company, the nature of its business and its value chain. Company-related issues (i.e. those to be managed in-house) should be distinguished from external metrics and topics (i.e. those related to external stakeholders, such as suppliers, clients and local governments).

COMPANY-RELATED METRICS AND TOPICS

- **Internal organisation:** innovation support (e.g., R&D spending, patents), workforce metrics (e.g., turnover, absenteeism rate), links with unions
- **Talent management:** company attractiveness, internal mobility, skill training
- **Human resource efficiency:** productivity
- **Diversity:** age distribution, gender balance, socio-economic balance, international balance
- **Health and safety:** injury rates, severity rates, site safety, safety training
- **Business culture:** ethics, fairness

EXTERNAL METRICS AND TOPICS

- **Suppliers:** outsourcing, type of suppliers (complexity of the supply chain, degree of interdependence), balance of power, hidden costs, geographical risks
- **Clients:** brand image, data security, product safety, new consumption practices
- **Foreign market operations:** appropriate monitoring structures, especially if in emerging markets; possible exclusions
- **Community and society:** relationship with local governments, regulators, unions, NGOs, trade or professional association, local communities

ENGAGEMENT

One of the areas of engagement on social issues is to assess a company's awareness of suppliers' labour practices (e.g., respect for human rights) or of supply chain financing, and the use of agreements such as reverse factoring.

GOVERNANCE ISSUES

Governance metrics and topics for discussion are mostly, but not exclusively, related to transparency, especially how clear and up-to-date the information is.

- **Board:** composition, independent members' profiles, separation of CEO/chair roles, diversity; executive compensation structure (financial and non-financial elements)
- **Corporate structure:** legal entities and, if it is a group, guarantees (disclosure should be simple and explicit)
- **Respect of capital providers:**
  - Minority shareholders
  - Creditors, including disclosures of the most relevant bank covenants (with definitions and calculation when appropriate), explicit debt ranking and guarantees/subordination
- **Risk control:**
  - History of bribery, cartel formation, fraud, litigation
  - Internal measures taken after emergence of controversies or litigation (remediations) and how these have improved the business or financial profile
- **Audit:**
  - Audit committee: composition, members' background
  - Auditors: seniority of the mandate, remuneration
- **Affiliations:** Is the issuer a signatory of a business platform (e.g., the UN Global Compact; the World Business Council for Sustainable Finance; or other professional or industry standards such as the Equator Principles for banks)? If so, with what level of commitment?
- **Reporting frameworks:** has the issuer adopted any reporting framework, such as the GRI, SASB, TCFD?
- **History and organisation of corporate social responsibility (CSR):**
  - Existence of an individual or a team responsible for CSR
  - Scope, appointment criteria, reporting line
  - Integration into the corporate strategy, how CSR guidelines are decided

ENGAGEMENT

- **Management accessibility:** management approachability and openness can provide (positive/negative) signals about governance
- **Other questions:**
  - How has the issuer's sustainability/ESG consideration evolved?
  - Are developments monitored? What works well and what does not?
  - How are the group's employees involved?

CREDITS

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The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

PRI Principles for Responsible Investment

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

UN environment programme | finance initiative

United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org

United Nations Global Compact